No. 15,181

IN THE

United States Court of Appeals

For the Ninth Circuit

JOHN P. DALEY, MINERVA B. DALEY, MORRIS DALEY, ZELMA B. DALEY, WILLIAM RADTKE, CLARA RADTKE and HOMER BOSSE, Trustee of the Estates of Morris K. Daley, Alice M. Daley, Susan R. Daley, James D. Daley, Kathryn F. Daley and Peter D. Daley,

Appellants,

vs.

UNITED STATES OF AMERICA,

Appellee.

On Appeal from the Judgment of the United States District Court for the Northern District of California.

BRIEF FOR THE APPELLEE.

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BRIEF FOR THE APPELLEE.

OPINION BELOW.

The decision of the District Court (R. 102-112) is reported at 139 F. Supp. 376.

JURISDICTION.

This appeal involves federal income taxes. The tax returns in dispute were filed March 15, 1943, for the

calendar year 1942. (R. 22-23.) Claims for refund, based upon the operation of Section 6 of the Current Tax Payment Act of 1943, c. 120, 57 Stat. 126, were filed on March 15, 1947, for the years 1942-1943. (R. 23-24, 93-95.) Amended claims for refund were filed on April 9, 1951 (R. 23-24, 97-99) in the total amount of $77,782.78 (R. 12-13). The original and amended claims were rejected on March 21, 1952. (R. 96, 100.) Within the time provided in Section 3772 of the Internal Revenue Code of 1939 and on August 20, 1952, taxpayers brought an action in the United States District Court for the Northern District of California for recovery of the taxes paid. (R. 3-13.) Jurisdiction was conferred on the District Court by 28 U. S. C., Section 1340. The judgment was entered on March 23, 1956. (R. 112-113.) Within sixty days and on May 22, 1956, a notice of appeal was filed. (R. 114.) Jurisdiction is conferred on this Court by 28 U. S. C., Section 1291.

QUESTIONS PRESENTED.

1. John P. Daley and Morris Daley had been engaged in the construction business as partners for several years, reporting income on the completed contract basis. In 1942, they formed Daley Brothers, Limited, which, in turn, entered into a separate partnership or joint venture with William Radtke to perform a Government construction contract. The contract was completed in February, 1943. The joint venture submitted a federal income tax return for the

calendar year 1942, computing income by the accrual method of accounting and reporting the entire receipts from the contract. In 1947, claims for refund were filed attempting to shift the income from the contract, originally reported in 1942, to 1943, a year in which taxpayers sustained losses, to take advantage of these losses and the forgiveness provisions of the Current Tax Payment Act of 1943. The basis of the claims was that the venture had in fact adopted the completed contract method of accounting in 1942 and had erroneously reported the contract receipts in 1942, rather than 1943, when the contract was completed. The question presented is whether the District Court erred in finding that the venture intentionally elected to compute the income from the contract by means of the accrual method of accounting and did, in fact, adopt that method, rather than the completed contract method, for purposes of reporting its 1942 income tax liability.

2. Taxpayers claim, in the alternative, that since they have been held to have reported the joint venture income on the accrual basis in 1942, they should be permitted to correct alleged errors in the accrual computation, whereby they included, in 1942 income, amounts of income which did not accrue until 1943 and should, therefore, have been reported in 1943 rather than 1942. The additional question is thus presented as to whether the taxpayers can, in this action, correct the joint venture's accrual computation, inasmuch as the taxpayers' claims for refund, amended tax returns, complaint, evidence and District Court

brief were all based on a different ground (i.e., that *all* of the contract receipts had been erroneously reported as income in 1942 as a result of a mistaken application of the completed contract method) and the question of the adjustment of the accrual computation is urged for the first time on appeal.

STATUTES AND OTHER AUTHORITIES INVOLVED.

The statutes and other authorities involved are set forth in the Appendix, *infra.*

STATEMENT.

The facts as found by the District Court (R. 107-110) and as stipulated (R. 16-24) may be summarized as follows:

John P. Daley and Morris Daley since 1935 were engaged in the general contracting business, as co-partners, operating under the firm name of Daley Brothers. During this time they reported their income on the completed job basis of accounting. On June 30, 1942, the brothers, and their respective wives, executed identical trust agreements for the benefit of their children, differing only as to the beneficiaries, naming Homer Bosse as trustee. On the same date a new, limited partnership was created, composed of John P. Daley and Morris Daley, as general partners, and Homer Bosse, trustee, as limited partner, and the business was continued as Daley Bros., Ltd. On

July 8, 1942, the limited partnership entered into a Government contract (War Department Contract No. W-2195-eng-247), taken in the name of Daley Bros., for the construction of a Japanese Relocation Center at Delta, Utah. Upon the securing of this contract (hereinafter called the Delta contract), Daley Bros., Ltd., entered into a special partnership or joint venture with William Radtke, known as the Daley Brothers Delta War Venture (hereinafter called the Delta War Venture), for the purpose of performing the contract. (R. 18-19, 108.) It is the accounting treatment of the proceeds of the Delta contract by the Delta War Venture which is here in issue.[1]

The Delta contract called for a lump sum consideration of $2,834,212.51 and was to be completed on or before September 6, 1942. (R. 19.) It provided for periodic progress payments to be made at the end of each month, based on estimates made and approved by the Government contracting officer. It further provided that ten per cent of each payment would be retained by the Government until final completion and acceptance of all work under the contract. (Stip. Ex. 1; R. 19, 45.) A series of supplemental agreements increased the consideration to its final amount of $3,653,259.12 and extended the date of completion

[1]Appellants in this case are John P. and Minerva B. Daley, husband and wife; Morris and Zelma B. Daley, husband and wife; William and Clara Radtke, husband and wife, and Homer Bosse, trustee of the estates of Morris K., Alice M., Susan R., James D., Kathryn F. and Peter D. Daley, all of whom are joined herein as a result of filing individual income tax returns reflecting shares of income from the Delta War Venture. (R. 17-18, 22-24.) Hereinafter, the appellants will sometimes be referred to as taxpayers.

to February 16, 1943. (R. 19-21.) The Delta contract was completed and the work accepted by the Government as of February 16, 1943, although certain matters, including final payment, were not finally settled until a later date. (R. 21, 108-109.)

The Delta War Venture filed a separate partnership income tax return for the period June 1, 1942, to December 31, 1942, reporting gross income from the Delta contract of $3,655,672.28 and net income of $206,250.44, distributing such net income as follows: Daley Brothers, limited partnership, $144,166.96 and William Radtke, $62,083.48. (Stip. Ex. 18; R. 22, 86-87.) The amount reported in 1942 by the Delta War Venture was the full contract price of the Delta contract. (R. 109, 110.)

In 1947, the Delta War Venture filed amended partnership income tax returns for 1942 and 1943, in which it reported no income from the Delta contract in 1942 and the entire receipts from the contract in 1943. Along with these amended partnership returns, taxpayers filed claims for refund and amended individual tax returns reflecting the changes made by the partnership returns. (R. 109-110.)

The claims for refund asserted that the amended income tax returns filed in 1947 were consistent with the accounting procedure followed by Daley Brothers during 1943 and prior years (i.e., the completed contract method) and were to correct the reporting of the income from the Delta contract which was completed in 1943 and erroneously included in income for

the year 1942. (R. 94, 99, 109-110.) Upon rejection of these claims (R. 96, 100), taxpayers filed a complaint in the District Court alleging that the accountant for Daley Brothers acted under the mistaken assumption that the monies received under the Delta contract were income for the year 1942 and that such monies were not income for any year until the contract was completed and accepted (completion and acceptance not being made until 1943). The complaint further alleged that at the end of the calendar year 1942 an income tax return was made for the special partnership, notwithstanding the fact that the contract was not completed and accepted before December 31, 1942, and that the tax return for 1942 was erroneously made and reported under the mistaken theory that the income was earned in 1942. (R. 10-11.)

The District Court found that all the income from the contract was intentionally reported as accruing during 1942 and the accrual method of accounting was elected by the Delta War Venture. (R. 109, 110.) The court further concluded that taxpayers, in their refund claims and complaint, sought refunds solely on the ground that all of the contract receipts had been erroneously reported as income in 1942 as a result of a mistaken application of the completed contract method of accounting and that, therefore, any error resulting from a mistaken application of the accrual method cannot be reached or corrected in this action. (R. 104-105, 106, 111.) Accordingly, the court held that taxpayers were not entitled to any recovery and dismissed the complaint. (R. 111.)

SUMMARY OF ARGUMENT.

I.

Daley Bros., Ltd., entered into a special partnership with William Radtke to perform a Government construction contract. The contract was originally scheduled to be completed on September 6, 1942, for a fixed fee of $2,834,212.51, but several change orders extended the completion date to February 16, 1943, and the contract price to $3,653,259.12. The contract was completed and accepted on February 16, 1943, although certain matters were not finally settled until the following September. The special partnership reported all the receipts from the contract in its 1942 tax return as income for that year.

In 1947, taxpayers filed claims for refund and amended tax returns, which were disallowed by the Commissioner, reporting no income from the contract in 1942 and all of the receipts from the contract as income in 1943. In their suit for refunds, taxpayers claimed they in fact elected to report the contract income by the completed contract method and erroneously applied that method in reporting the income in 1942, since the contract was not completed until 1943. The Government contended that taxpayers intentionally elected to adopt the accrual method and may not now change to the completed contract method merely to shift income from 1942, a year of gain, to 1943, a year in which taxpayers sustained losses. The District Court held that taxpayers intentionally elected to report their income on the accrual basis. The question of whether taxpayers elected the accrual basis or the

completed contract basis is one of fact and the findings of the District Court should not be disturbed unless clearly erroneous.

The applicable statutory provisions and Regulations authorize persons whose income is derived from "long term" construction contracts to elect either the accrual basis or the completed contract basis as the method upon which they may report their income. Under the accrual method, income is reported, and deductions are taken, in the period in which the right to receive payment, or the liability to pay, becomes fixed; under the completed contract method, income and expenditures with respect to a particular contract are reported in the period in which the contract is completed. In comparing the two methods, the day-to-day recording of income and expenditures may be done by the accrual or some other method and yet either the accrual or completed contract method may be elected to report the net profit for a particular period. The facts surrounding the election are, therefore, of primary importance in determining which method was employed. The facts in this case clearly indicate that taxpayers did not elect to report the special partnership income on the completed contract basis and did, in fact, elect to utilize the accrual basis and the District Court was correct in so holding.

During the year, books were kept on the accrual basis. More important, the facts surrounding the point of election, i.e., the end of the calendar year, indicate that taxpayers could not have had the slightest doubt that the contract was not completed until 1943. Tax-

payers' accountant testified that he thought the contract was completed in 1942 and reported the income therefrom on the completed contract basis; the District Court properly held that, under the facts of this case, such testimony was not credible. In addition, both taxpayers and the accountant were perfectly aware that, under the completed contract method, income from the contract was not to be reported until the contract was completed and accepted. The fact that all the parties knew that the contract had not been completed in 1942 and that, under the completed contract method, such income should not be reported until the year of completion, is strong proof that the completed contract method was not utilized. It is inconceivable, in face of such obvious facts, that taxpayers reported the contract income in 1942 and yet elected to employ the completed contract method. The alleged error committed with respect to utilization of the completed contract method (i.e., the reporting of the contract income before the contract was completed or even considered so by the taxpayers) is so striking and obvious as to suggest that it did not occur at all and that the taxpayers did not elect the completed contract method.

In addition to the proof that taxpayers did not elect to employ the completed contract method, the fact which they had the burden of establishing, there is affirmative evidence to support the District Court's finding that the income from the contract was intentionally reported as accruing during 1942. Taxpayers, on January 26, 1943, filed a form with the United

States Department of Engineers, on which they clearly indicated that the basis used for reporting the income from the contract for income tax purposes was the accrual, and not the completed contract, basis. Taxpayers' subsequent efforts, years later, to explain away this clear and contemporaneous documentary expression of intent lack plausibility. Taxpayers, on the special partnership tax return itself, indicated the accrual basis was used; in addition, Mr. John P. Daley wrote to Mr. Radtke, on December 31, 1942, setting forth the latter's specific share in the profits, as of that date, a fact indicating profits were computed on the accrual basis, at the end of the accounting period and prior to completion of the contract.

The accounting and other evidence set forth by taxpayers does not prove that they elected to employ the completed contract basis nor does it prove they did *not* elect to utilize the accrual basis. As the District Court noted, the most it shows is that taxpayers erroneously computed their income for 1942, electing the accrual method, but misapplying it.

Taxpayers also argue that if they did not elect the completed contract method, then the method utilized, be it accrual or otherwise, is unacceptable in this case since it does not clearly reflect the income of the special partnership and they should be allowed to utilize the completed contract method, which is the *only* method that will clearly reflect income. This contention improperly assumes that the method employed by taxpayers reports income that was not earned at all in 1942 and also improperly assumes

that the accrual methods will not clearly reflect income. The accrual method is a recognized and accepted method of reporting income from a fixed-fee contract, with periodic partial payments and, if properly applied, will correctly allocate the profit or loss of a taxpayer earning income under such a contract to the proper year. It appears that certain errors were made in the accrual computation, but if these were corrected, it is submitted that the accrual method would clearly reflect the income from this contract for the year 1942. The record does not provide a factual basis for computing the correct income under the accrual method and, in addition, as discussed in Point II, taxpayers are precluded from correcting the accrual computation in this action.

Finally, taxpayers' argument that their election to report on the accrual basis was an innocent mistake, from which they should be relieved, is without merit, there being no misapprehension on the part of the taxpayers with respect to the law or their rights thereunder.

II.

Taxpayers claim, in the alternative, that since they have been held to have reported the special partnership income on the accrual basis, they should be permitted to correct asserted errors in the accrual computation. The District Court noted that, although such errors apparently existed, they could not be corrected in this action. The District Court was correct in this conclusion, since a taxpayer may not urge, as a basis

for recovery in a tax refund suit, any ground which was not set forth in his claim for refund. In this case, the claims for refund, amended tax returns, complaint, evidence and taxpayers' District Court brief were all based on the ground that all of the contract receipts had been erroneously reported as income as a result of a mistaken application of the completed contract method and should have been reported in 1943, when the contract was completed. Taxpayers cannot now claim recovery based on the ground that they incorrectly calculated their income on the accrual basis. Since this latter ground was at no time in issue, the District Court's observations with respect to the erroneous accrual computation might even be deemed dicta and the taxpayers are actually raising the question for the first time on appeal. Taxpayers cannot urge as a ground for reversal an issue which they raise for the first time on appeal.

ARGUMENT.

I.

THE DISTRICT COURT CORRECTLY HELD THAT TAXPAYERS ELECTED TO REPORT THE INCOME FROM THE DELTA CONTRACT BY MEANS OF THE ACCRUAL METHOD.

On July 8, 1942, Daley Bros., Ltd. (a limited partnership, which had been formed on June 30, 1942, and was comprised of John P. Daley and Morris Daley, general partners, and Homer Bosse, limited partner), entered into a construction contract with the United States to construct a Japanese Relocation

Center at Delta, Utah. Upon securing this contract, the limited partnership entered into a special partnership, or joint venture, with William Radtke, called the Daley Brothers Delta War Venture, for the purpose of performing this contract. The contract was originally scheduled to be completed on September 6, 1942, for a fixed fee of $2,834,212.51, but several supplemental agreements and change orders extended the completion date (which finally, on December 5, 1942, was extended to February 16, 1943) as well as increased the contract price to $3,653,259.12. The contract was in fact completed and accepted as of February 16, 1943, although certain matters were not finally settled until September, 1943. The Delta War Venture filed a partnership income tax return for the year 1942 in which it reported as income all of the receipts from the Delta contract.

In 1947, taxpayers filed amended returns for the Delta War Venture for the years 1942 and 1943, reporting no income from the contract in 1942 and all of the receipts from the contract as income in 1943. Along with these amended returns, taxpayers filed claims for refund and amended individual returns, reflecting the shifting of the income from the Delta contract from 1942 to 1943. (R. 22-23, 103-104.)

The sole question presented to the District Court in this case was whether the taxpayers elected to report the income from the Delta contract, in the return of the Delta War Venture, by means of the accrual method of accounting or by the completed con-

tract method of accounting. The Government contended that taxpayers intentionally elected to adopt the accrual method and may not now change to the completed contract method; taxpayers claimed that they had in fact elected to report the income by the completed contract method and erroneously applied that method in reporting the income in 1942, since the contract was not completed until 1943. (R. 104-105.) The District Court found that all of the income from the contract was intentionally reported as accruing during the year 1942 and concluded that the Delta War Venture elected to report the income from the contract for the year 1942 on the accrual basis of accounting. (R. 110, 111.) The question of whether taxpayers elected the accrual method or the completed contract method is purely factual and the findings of the District Court in that respect should not be disturbed unless clearly erroneous. Federal Rules of Civil Procedure, Rule 52(a). See *Niles Bement Pond Co. v. United States,* 281 U. S. 357, 360.

The general rule with respect to methods of accounting for income tax purposes is that the net income shall be computed upon the basis of the taxpayer's annual accounting period in accordance with the method of accounting regularly employed in keeping the books of such taxpayer. If the method does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. Sec. 41, Internal Revenue Code of 1939 (Appendix, *infra*). The statute further provides that the

amount of all items of gross income shall be included in the gross income for the taxable year in which received, unless, under methods of accounting permitted under Section 41, any such amounts are to be properly accounted for as of a different period. Sec. 42(a), Internal Revenue Code of 1939 (Appendix, *infra*). Finally, deductions are to be taken for the taxable year in which "paid or accrued" or "paid or incurred," dependent upon the method of accounting upon which the net income is computed, unless, in order to clearly reflect the income, the deductions should be taken as of a different period. Sec. 43, Internal Revenue Code of 1939 (Appendix, *infra*).

It is elementary that these statutory provisions, and the Regulations promulgated thereunder,[2] recognize and authorize the two principal methods of recording and reporting items of income and expense, i.e., the "cash" method and "accrual" method. Under the "cash" method, income is reported in the year of actual receipt and deductions are taken in the year of actual expenditure. Under the "accrual" method, income is reported in the period in which the right to receive the cash or property accrues or becomes fixed, irrespective of the time of actual receipt. Similarly, deductions are taken in the period in which they were incurred, i.e., when the liability to pay becomes fixed, even though payment is not presently due and irrespective of the period of actual payment. *Spring City Co. v. Commissioner,* 292 U. S. 182; *Brown v.*

[2]Treasury Regulations 111, Secs. 29.41-1 and 29.41-2 (Appendix, *infra*).

Helvering, 291 U. S. 193; *Clark v. Woodward Construction Co.,* 179 F. 2d 176 (C. A. 10th). In addition to these principal methods, persons whose income is derived in whole or in part from "long-term" building, installation or construction contracts may elect to report the gross income from such contracts either upon the basis of the *percentage of completion* of the contract or upon the *completed contract* basis (in which the gross income from the contract is reported in the period the contract is finally completed and accepted and the expenditures during the life of the contract, and allocable thereto, are deducted in the same period).[3] Treasury Regulations 111, Sec. 29.42-4 (Appendix, *infra*).

It should be noted, in comparing the accrual and completed contract methods of accounting, that the primary accounts for income and expense items may be *recorded* as a day-to-day matter by one method or the other—the essential difference between the two methods is in the election as to when the recorded items are to be carried into profit and loss for the particular period and reported. Thus, under the completed contract method, although items of income and expense are recorded in the primary accounts when accrued or incurred, such items are not carried into profit and loss (and the tax return for a particular year) until the contract is completed. *Fort Pitt Bridge*

[3]This Court has held that this regulation must be interpreted literally and income computed on the completed contract basis must be reported when completed and accepted, not merely when substantially completed. *E. E. Black, Ltd. v. Alsup,* 211 F. 2d 879 (C.A. 9th).

Works v. Commissioner, 92 F. 2d 825 (C.A. 3d); *Badgley v. Commissioner,* 21 B. T. A. 1055, 1058-1059; 2 Mertens, Law of Federal Income Taxation, Sec. 12.134. Since it is not inconsistent to say that the primary recording of the financial data is done on an accrual basis, but the profit and loss determined on either the accrual or completed contract basis, as the taxpayer elects, it is necessary to view the facts surrounding the point of election of one method or another for purposes of determining and reporting the income, rather than the method employed in the day-to-day recording of the income and expense items.

Without discussing the entries made to set up the contract on the books and record the various items of income and expense *during* the year in detail, the testimony of taxpayers' own expert witness, who also supervised the books of account in the years in question, clearly indicates that such entries were made on the accrual basis. (R. 216, 224, 233-235.) More important, the facts indicate that taxpayers elected to determine the profits of the Delta War Venture on the accrual basis and clearly did not intend to determine and report such income on the completed contract basis.

As the District Court noted (R. 105-106, 110), at the time the tax return was filed the taxpayers could not have had the slightest doubt that the contract was not completed until 1943. As of December 5, 1942, the contract had been extended an additional seventy-three days, to February 16, 1943, by a change order, a fact which had been acknowledged by John

P. Daley, on December 5. (Stip. Ex. 12; R. 77-78.) Taxpayers received, and acknowledged, on April 27, 1943, a letter from the contracting officers of the Corps of Engineers stating the contract was accepted and completed as of February 16, 1943, a fact which corroborates the position that taxpayers knew, as of the time the return was filed, that the contract was not completed until 1943. (Ex. D; R. 196-197.) Finally, John P. Daley testified (R. 203) that he personally did not consider the job was done from the point of view of a completed contract until as late as September, 1943, because of certain adjustments which had to be made concerning an item of lumber. He expressly stated, with respect to the status of work under the contract on December 31, 1942, that (R. 149-150) the work had not been accepted and there were a number of miscellaneous items which were not yet completed. In addition, Mr. Daley clearly indicated he realized that profits were not to be reported, under the completed contract method, until the work was completed and accepted. (R. 188.)

Taxpayers' certified public accountant, who checked and supervised the records and many of the entries, closed the books and made out the tax returns in the years in question (R. 218), and who clearly knew that the profits of a contract were not to be reported under the completed contract basis until the contract was completed (R. 213-214), testified that the completed contract method was used to determine the profit from the Delta contract (R. 217). He testified that he made the closing entries because he was under the

impression that the contract had been completed in 1942, having had information that the job had been completed. (R. 219, 222, 227.) However, the accountant was unable to give any credible testimony as to what information he had received; he stated it was his recollection that all the equipment and persons of authority had been returned to San Francisco in November or December (R. 221, 240),[4] and that somebody had informed him that the work had been completed (R. 221). It would seem logical that both the information that a large contract had been completed and the authority to report the profits on the completed contract basis at that time would come, if at all, from one of the taxpayers. In view of the fact that taxpayers clearly did not consider the contract completed, the accountant's assertions seem to lack credibility and the District Court was correct in so holding. (R. 106.) An additional fact that indicates the accountant knew the contract was not in fact completed in 1942 is that certain amounts were included in the gross receipts from the contract even though they represented increases in the contract price which first arose in change orders issued *in 1943* (R. 21, 222-223); it would seem that the accountant, who supervised the books and made the closing entries, would be aware of this fact.

While it is true, as taxpayers state (Br. 16), that the fact that all the parties knew the contract had not

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[4]This information seems completely in conflict with the fact that the completion date of the contract had been extended in December for an additional seventy-three days, presumably at the request of taxpayers.

been completed in 1942 does not affirmatively prove the accrual system was used, it is strong proof that the completed contract method was not elected. It is completely incongruous to state that taxpayers elected to report income on the completed contract basis in 1942 when the contract was, as obvious to all concerned, not completed until 1943. There at no time seems to be any question in the minds of the taxpayers or their accountant that substantial completion of the contract would not suffice and that the fundamental feature of the completed contract method was that income was reported only when the contract was completed. The record clearly indicates that taxpayers did not consider the contract completed in 1942, yet chose to report the income on the contract in that year regardless of that fact.

In addition to the foregoing proof that taxpayers did not elect to report the income from the Delta contract on the completed contract basis, there is affirmative evidence to support the District Court's finding that the income from the contract was intentionally reported as accruing during 1942. John P. Daley, on January 26, 1943, filed a form with the United States Engineer Department in which he clearly indicated that the basis used in reporting the revenue from the Delta contract for income tax purposes was the *accrual* basis. The form clearly provided spaces to be checked for the completed contract basis, cash receipt basis and accrual basis and Mr. Daley certified that the joint venture was utilizing the accrual basis for tax purposes. (R. 80-83.) The

taxpayers' attempts to explain away this clear documentary expression of intent (R. 185-188) lack plausibility. The assertion that the contracting officer demanded that taxpayers close their books as of December 31, 1942, so that he could "get off and go to war" (Br. 14) appears a bit far-fetched; furthermore, the Army could perhaps dictate renegotiation procedures, but there was no forced relationship between the renegotiation provisions and the manner in which taxpayers elected to file their income tax return. There is nothing in the record to prove that the provisions of the particular Renegotiation Regulations relied upon by taxpayer (Br. 15), which were not in force in the tax years in question, were administratively in force in those years. Moreover, the Renegotiation Regulations did not *require* the use of the completed contract method. If such method was used for tax purposes, it was not required to be used for renegotiation purposes in all cases, as taxpayers seem to suggest. (Br. 15.) The Regulations provided that under ordinary circumstances a contractor would be renegotiated on the same basis as he used for federal income tax purposes, but provision was made for contractors to be able to request a change of basis. Sec. 1603.302, 32 Code of Federal Regulations c. XIV, pp. 2835, 2859 (1944 Supp.) (Appendix, *infra*). Even if taxpayers were forced by the Army to report on the accrual basis and even if it was disadvantageous to them to report on the completed contract basis because of renegotiation provisions (thus causing taxpayers to elect the accrual basis), such facts would

merely add weight to the position that the accrual method was elected. The alleged fact that Daley, not knowing what the accrual basis was, marked that space only to avoid marking "Completed Contract" is without support in the record and likewise implausible—one might ask why Daley did not mark the "Cash Receipts" space instead. (R. 82.) Taxpayers' remaining contentions with respect to this document (Br. 16) are likewise without merit. It is submitted that the contemporaneous expression of intent represented in the document filed on January 26, 1943, is strong evidence of taxpayers' election of the accrual method. Mr. Daley's subsequent effort, years later, to explain away this evidence is weak in and of itself and becomes more so in view of the fact that, as the District Court noted (R. 106), it has become advantageous *ex post facto* to shift the income from 1942, a year of gain, to 1943, a year of loss (in addition to obtaining certain advantages under Section 6 of the Current Tax Payment Act of 1943, c. 120, 57 Stat. 126). Finally, Mr. Daley wrote to Mr. Radtke, on December 31, 1942, specifically setting forth the fact that his share from the ventures to date was $65,597.77 (R. 139-141); the drawing off of such an accurate profit figure, before the contract was complete, indicates profits were computed on the accrual basis.[5]

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[5]Taxpayers also try to write off as immaterial the fact that they stated, on the Delta War Venture tax return, that such return was prepared on the accrual basis. (Br. 13.) This fact is certainly of some probative value; taxpayers could have specified some other method, if such were utilized, even though the form provided only "cash" and "accrual" spaces. The fact that they *subsequently* filed an amended return, which was admittedly on the completed con-

Taxpayers contend that the District Court disregarded the direct evidence of the accounting facts (Br. 7) and that the accounting evidence demonstrates why the method employed was not the accrual method (Br. 11). It is true that, in determining whether a taxpayer has elected to report income on the cash basis or accrual basis, examination of the books and records for day-to-day entries involving inventories and accrual items of receipts and disbursements, such as receivables and payables, provides strong evidence of which method was in fact elected. See *Aluminum Castings Co. v. Routzahn,* 282 U. S. 92, 99. But the difficulty encountered with respect to such an approach in a case in which the determination is to be made between accrual and completed contract methods is that the day-to-day entries are not necessarily controlling, although they are of some probative value, since they could be made on one basis (such as the accrual basis, as was admittedly done in this case) and yet be taken into profit and loss on another basis (the completed contract basis, as taxpayers herein contend). The facts surrounding the point of election, including those not necessarily part of the accounting records, are of great importance. As the District Court properly noted (R. 105),

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tract basis, and marked the same space should not be given much weight, in view of the later, self-serving nature of such a fact. *Aluminum Castings Co. v. Routzahn,* 282 U. S. 92, 98, relied upon by taxpayers (Br. 14), involved a situation in which the taxpayer asserted that its declaration on its tax return should control. That case is clearly distinguishable from this one, in which taxpayers assert that their declaration should *not* be considered as even probative of their election of an accounting method.

the fundamental feature of the completed contract basis is that it is a practice of treating receipts from a contract as income as of a particular time, i.e., the completion date of the contract. As already fully discussed, it was obvious to both the accountant and the taxpayers that the contract was not completed and they both knew that until such fact existed they should not report the income from the contract. It is thus inconceivable that, in face of such an obvious fact, taxpayers reported the contract income in 1942 and yet elected the completed contract method. It is submitted that the alleged error committed with respect to utilization of the completed contract method (i.e., the reporting of the contract income before the contract was completed or even considered so by the taxpayers) is so striking and obvious as to lead to the conclusion that it did not occur at all, but is merely a hindsight effort to shift income from one period to another.

The accounting evidence set forth by taxpayers (Br. 11-12) does not prove that taxpayers were *not* on the accrual basis nor does it prove that they elected the completed contract method (the latter is, of course, the fact which taxpayers had the burden of establishing). The most that taxpayers can claim for this evidence is that it shows that they made certain errors with respect to the utilization of the accrual method. Taxpayers' opening entries, setting up the contract on the books as a receivable, and the similar entries with respect to the subsequent increases in the contract price (R. 223-224, 225-227) were all made on

the accrual basis, a fact which taxpayers' accountant confirmed (R. 216, 220, 224). The fact that taxpayers did not later adjust the entries so as to defer the amount of the retained percentage hold-back is merely an error in the determination of income on the accrual basis, as would be any failure to adjust such accounts for work not yet estimated and approved, in accordance with the contract. (R. 45.) See *Dally v. Commissioner,* 20 T.C. 894, affirmed, 227 F. 2d 724 (C. A. 9th), certiorari denied, 351 U. S. 908.[6] Taxpayers also note (Br. 12) that certain costs were brought into the 1942 computation of income, though not technically incurred in that year. The record is not at all clear whether these costs were in fact not incurred until a later year;[7] furthermore, this assertion is offset by the fact that several other costs, which were definitely established to have been incurred in 1943, were *not* related back to 1942. (R. 229-232.) Taxpayers' accountant admitted (R. 232) that the books did not

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[6]Income from a fixed-fee contract (with provisions for partial payments based upon periodic approved estimates) is determined on the date of the estimate. *Dally v. Commissioner, supra.* Since taxpayers' refund claims and suit were based upon the theory that they were always on the completed contract basis, the record is not clear as to how much income had accrued. The record merely shows the "Amount of Contract Completed" and "Amount Paid on Voucher" (R. 79), but not the amount estimated and approved.

[7]The accountant's testimony (R. 220-221) with respect to the expenses is sketchy and qualified and, in fact, seems to indicate that although billings had not yet been received by taxpayers, the services and merchandise purchased had been received and an indebtedness was considered to have occurred. Once again, the record insofar as accrual of expenses is concerned, is insufficient, apparently because the sole issue was whether taxpayers were on the completed contract basis and the proper computation of income on the accrual basis was not in issue.

disclose that the contract was completed in 1942. These facts illustrate that the books were not kept or closed on the completed contract basis and, together with the other evidence of taxpayers' intent, clearly support the District Court's finding that taxpayers elected to report their income on the accrual basis.

The other evidence taxpayers present to prove that the completed contract method was employed (Br. 12-13) is of doubtful value. As noted by the District Court (R. 106) and already fully discussed, the testimony of the accountant was not credible. The fact that John P. Daley testified that no return was filed in 1943 for the Delta War Venture because the 1942 return showed the contract as completed proves no more than, as just discussed, that the accrual method was improperly applied. In fact, this testimony conflicts with the fact that certain items of contract expense were in fact incurred and reported in 1943. Finally, the facts that Daley Brothers had consistently employed the completed contract method, that jobs commenced in 1941 were closed in 1942, when completed, and that no new books were established for the joint venture with Mr. Radtke are immaterial. Apparently, taxpayers are attempting to renew the argument that they are required to consistently report on the same basis and require the Commissioner's consent to change accounting methods. Not having obtained such consent, taxpayers seek to infer that they were on the same basis as before. The District Court properly held (R. 103, 110-111) that Daley Brothers, Daley Bros., Ltd., and Daley Brothers' Delta War Venture

were each separate and distinct business entities.[8] The Delta War Venture was filing its first return in 1942 and thus taxpayers were free to elect any method of accounting allowed by the statute and Regulations. Moreover, the provision that the Commissioner's consent is required before a change in accounting method can be made is clearly optional on the part of the Commissioner and his consent can be implied from his acceptance of a new method without objection or other indication of his non-acquiescence. *Fowler Bros. & Cox v. Commissioner,* 138 F. 2d 774 (C. A. 6th); *S. Rossin & Sons v. Commissioner,* 113 F. 2d 652 (C. A. 2d).

Taxpayers also argue that if they did *not* keep their accounts in connection with the Delta contract on the completed contract method, then the method they utilized was unacceptable, since it did not clearly

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[8]Daley Bros., Ltd., was a new partnership formed on June 30, 1942, filing a certificate of doing business under that fictitious name on July 6, 1942 (R. 108), and the Delta War Venture was itself a new partnership, formed in July 1942, between the new limited partnership and Mr. Radtke (R. 19). The general partnership, limited partnership, Daley Brothers' Barracks Venture and the Delta War Venture all filed separate partnership returns in 1942 (R. 142, 144, 145, 146) and, as part of a protest filed by taxpayers with the Bureau of Internal Revenue November 15, 1944, John P. Daley stated the Delta War Venture operated as a separate partnership (R. 181, 183-184).

The fact that no new books were established does not alter the separate nature of the partnerships, as shown by the above facts. The jobs referred to as commencing in 1941 and being reported on the completed contract basis were commenced by the Daley Brothers general partnership and the $131 involved was reported on the limited partnership return; another such item, totalling $21,300, was reported on the general partnership return. (R. 174-177.) These two items, in which neither Radtke nor the Delta War Venture shared, show that these partnerships were separate and distinct from the Venture.

reflect income. (Br. 19-20.) They further assert that even if the method utilized was the accrual method, such method does not clearly reflect income in this case. (Br. 21-28.) Taxpayers then state that they should be allowed to compute income on the completed contract method since, they contend, that method is the only one which does clearly reflect income. Both arguments are essentially the same and the cases cited with respect to each are distinguishable from this case, either on their facts or the issues involved. Taxpayers' first argument improperly assumes that the method employed by them in the original Delta War Venture return for 1942 reports income that was not earned and they are entitled to adopt a different method. Taxpayers' second contention improperly assumes that the accrual method, properly applied, would still not clearly reflect income and only the completed contract basis would do so. The fact is that in cases involving a fixed-fee contract, with periodic partial payments as work progresses, taxpayers may elect either method; the accrual system, *if properly applied,* will clearly reflect the taxpayer's income. See *Dally v. Commissioner, supra;* I. T. 3459, 1941-1 Cum. Bull. 236 (Appendix, *infra*). Thus, if taxpayers had properly applied the accrual method, which they elected to employ, they would have adjusted their accounts by the amount of the retained percentage hold-back and by any amounts not yet estimated, approved and certified, and would have deducted the expenses for which they had incurred a definite liability. This would have resulted in the

proper reflection of income, under the accrual method, for the year 1942, whether the result be a profit or loss for that particular year. Taxpayers contend that the accrual method, properly applied, would result in a loss of $266,471.71 for 1942 and net income of approximately $472,722.15 in 1943. (Br. 24.) The propriety of these amounts cannot be ascertained, however, because the record is void of facts which would enable the accrued receipts, incurred expenses and net profit or loss to be computed on the accrual basis. The record merely shows the amount of the contract completed, $3,353,828.39, and the amount paid on vouchers, $3,180,536.97, as of December 1, 1942. (R. 79.) The amounts of certified estimates (which would fix the accrued income) are not disclosed; of particular significance would be the amount of such estimates existing as of December 1, 1942, and any additional estimates during that month. Information concerning the status of expenditures is also almost completely lacking. (See footnotes 6 and 7, *supra.*) The resulting profit or loss, computed on the accrual basis, would not be "fictitious," as taxpayers assert. (Br. 24.) It is basic that net profit for income tax purposes is computed on an annual basis and, if the accrual method is used, a profit (or loss) might result for a particular year, even though the overall result on a particular transaction might be the opposite. The accrual method merely relates the income and expenses as they apply to the respective accounting periods in which the right to receive, or the obligation to pay, has become final and definite, resulting in

a proper reflection of income for that period. *Security Mills Co. v. Commissioner,* 321 U. S. 281.

Taxpayers' final argument, i.e., that any election to report on the accrual basis was an innocent mistake, from which taxpayers should be relieved (Br. 28-30), is without merit on the facts of this case. As already fully discussed, there was no misapprehension or mistake on the part of taxpayers with respect to the law or their rights in being able to report the income from the Delta contract upon either the accrual basis or the completed contract basis. They elected to report the income on the accrual basis with full knowledge of their right to report on the other basis if they desired to do so and cannot, in a later year, change the basis utilized in their original return merely for the sake of deriving some reduction of the tax due. *Commissioner v. Saunders,* 131 F. 2d 571 (C.A. 5th). The assertion that taxpayers have so far been denied the right to compute their tax liability in a correct manner stems from the fact that taxpayers improperly included some income in their accrual computation, a fact of their own doing, and one which cannot be corrected in this action (as developed in Point II, *infra*).

II.

TAXPAYERS CANNOT, IN THIS ACTION, CORRECT THE DELTA WAR VENTURE'S ACCRUAL COMPUTATION, INASMUCH AS TAXPAYERS' CLAIMS FOR REFUND AND COMPLAINT WERE BASED UPON A DIFFERENT GROUND.

Taxpayers now claim, in the alternative, that, since they have been held to have reported the Delta War Venture income on the accrual basis in 1942, they should be permitted to correct the alleged errors in the accrual computation. (Br. 30-38.) The District Court, in finding that taxpayers elected to report all of the income on the accrual basis in 1942, further noted that a portion of the income actually accrued in 1943, but concluded that refunds based upon correction of this error could not be granted in this action, since the grounds stated in the refund claims and the complaint were solely that all of the receipts from the contract had been erroneously reported as income in 1942 as a result of a mistaken application of the completed contract method of accounting. (R. 106, 110, 111.)

It is well-settled that a taxpayer who brings suit after a claim for refund has been denied can rely for recovery only on grounds presented to or considered by the Commissioner. The purpose of this requirement is to give the Commissioner notice of the nature of the claim and afford an opportunity for administrative adjustment without suit. *French v. Smyth,* 110 F. Supp. 795 (N.D. Cal.), affirmed *sub nom., French v. Berliner,* 218 F. 2d 351 (C.A. 9th); *Samara v. United States,* 129 F. 2d 594, 597 (C.A. 2d). As

stated in *Nemours Corp. v. United States,* 188 F. 2d 745, 750 (C.A. 3d):

> A long-standing statutory provision with regard to tax refunds is that suits may be brought only after a claim for refund has been filed with the Commissioner in accordance with the law and Treasury Regulations.[6] The Regulations governing refunds under the statute in question here provide that "The claim must set forth in detail * * * each ground upon which a refund is claimed, and facts sufficient to apprise the Commissioner of the exact basis thereof." Treas. Regs. 94, Art. 322-3 (1936).[7] It is to be noted that both the grounds for recovery and the facts supporting them must be shown. The taxpayer stated as its ground for refund Section 26(f) and made its computation accordingly. That does not, under the decisions, give him a right to claim under some other section. See especially *Real Estate-Land Title & Trust Co. United States,* 1940, 309 U. S. 13, 60 S. Ct. 371, 84 L. Ed. 542; *A. M. Campau Realty Co. v. United States,* Ct. Cl. 1947, 69 F. Supp. 133.

This is hard law, no doubt. Perhaps it is necessarily strict law in view of the scope of the operations of a fiscal system as large as that of the United States. Whether that is so we are not called upon to say. We apply the rule; we do not make it. It is to be observed that recovery of claims against the Government has always been

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[6]Rev. Stat. § 3226, as amended in § 1103 (a) of the Revenue Act of 1932, 47 Stat. 286. See Internal Revenue Code, § 3772, 26 U.S.C.A. § 3772.

[7]The present Regulations are to the same effect. Treas. Regs. 111, Sec. 29.322-3.

the subject of a strict compliance requirement. The recovery of claims for tax refunds is but an application of this broad and strict rule.[8]

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[8]See e. g. *Angelus Milling Co. v. Com'r,* 2 Cir., 1944, 144 F. 2d 469, 472, affirmed, 1945, 325 U.S. 293, 65 S.Ct. 1162, 89 L. Ed. 1619; *Maas & Waldstein Co. v. United States,* 1931, 283 U.S. 583, 589, 51 S.Ct. 606, 75 L. Ed. 1285; *Rock Island, Arkansas & L.R. Co. v. United States,* 1920, 254 U.S. 141, 143, 41 S.Ct. 55, 65 L. Ed. 188; *Nichols v. United States,* 1868, 7 Wall. 122, 126, 19 L. Ed. 125.

The facts clearly illustrate that taxpayers' claims for refund and action in the District Court were based upon the premise that taxpayers had elected to report the income of the Delta War Venture on the completed contract basis and, in fact, did so; taxpayers sought to prevail in their claims for refund because, they asserted, the completed contract method was misapplied, the contract income being reported in 1942, when the contract was not completed until 1943.

The amended claims for refund, by way of explanation of the precise nature of the claim, read as follows (R. 99):

> The following reasons that this claim should be allowed are in accordance with the original claims which were timely filed:
>
> The amended partnership returns were filed to correct the erroneous returns which were filed for years 1942 and 1943. The amended returns as filed are consistent with the accounting procedure used by Daley Brothers during the year 1943 and prior. The amended returns are to correct the Delta, Utah, contract which was completed in the year 1943 and erroneously included in income for

> the year 1942. The claim reflects the correct tax liability in accordance with sec. 6 of the current tax payment act of 1943, Public #68—78th Congress. Included in the correction is the amount of renegotiation refund which was erroneously deducted from income in the original 1942 return.

The claims, standing by themselves, are somewhat vague and, without more, might have been subject to a motion to dismiss for lack of failing to state specific grounds upon which the refund was demanded. See *J. H. Williams & Co. v. United States,* 46 F. 2d 155 (E.D. N.Y.). Insofar as they are at all specific, they indicate that taxpayers are seeking a refund based on application of the completed contract method (the method which Daley Brothers used in prior years for other partnerships, as outside facts disclose). (R. 18.) The language that the amended returns are to correct the Delta contract "which was completed in the year 1943 and erroneously included in income for the year 1942" (R. 99) further implies that application of the completed contract method was intended.

Whatever question exists as to the specific nature of the claims is clarified by reference to the amended tax returns for the Delta War Venture. (R. 88-92.) These were attached to the claims and clearly indicate that the basis of the claims is that taxpayers seek refunds based upon a correct application of the completed contract method. Contrary to the taxpayers' assertions (Br. 33), the amended return for 1942 completely drops all gross receipts, cost of goods sold

and net income from that year (carrying forward all receipts and costs to the following year) and the amended return for 1943 reports all the receipts and costs of the Delta contract in that year. This is perfectly consistent with, and indicative of, the completed contract method. There is no effort to allocate receipts or costs between the two years, as would have been done if taxpayers based their claims on a correction of the accrual basis.[9] Taxpayers virtually concede this point. (Br. 14, 36.) It is apparent that the claims are not sufficiently broad to encompass the contention that the accrual method was erroneously used in this case.

Similarly, as the District Court stated (R. 106), the complaint is based upon the allegations that taxpayers originally reported the income on the completed contract basis and, by mistake, considered the contract completed in 1942; it prays for relief which will shift all the income to 1943, the year in which the contract was in fact completed. Thus, taxpayers specifically alleged (R. 10-11):

> The accountant for Daley Brothers, acting under the mistaken assumption that the monies received under the said contract was income for income tax purposes for the year 1942, prepared financial statements for income tax returns that included

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[9]It is interesting to note that taxpayers now state that the amended and original returns were designated, on the returns, as being prepared on the accrual basis, seeking to infer that this is of probative value. (Br. 34.) This is directly contrary to their position with respect to this point insofar as it was discussed in the first issue. (Br. 13-14.)

> the monies received in 1942 under said contract. *That said monies received under the contract for the Delta Venture was not income for any year until the said contract was completed as provided for in the contract, and accepted by the United States Government.* That said completion and acceptance was not made until February 16, 1943. (Emphasis supplied.)

The remaining allegations, set forth in paragraphs VIII, IX and X of the complaint (R. 11-12), clearly illustrate that the theory of taxpayers' cause before the District Court was as heretofore set forth. The relief requested (R. 12-13) is in conformity with the claims for refund and the amended returns, which were on the completed contract basis, as taxpayer admits (Br. 36). The complaints, therefore, in no way set forth, as an alternative, that taxpayers should be allowed a refund based upon the proper application of the accrual method.[10]

The conduct of the trial itself corroborates the fact that taxpayers based their claim upon the ground set forth by the District Court. There is nothing in the testimony of John P. Daley (R. 137-212) which indicates that taxpayers were endeavoring to prove that the Delta War Venture was on the accrual basis or

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[10]Rule 54(c) of the Federal Rules of Civil Procedure, cited by taxpayers (Br. 36), should not be interpreted as to grant relief based upon grounds at variance with the claims for refund. The Rule specifically states that the judgment shall grant the relief *to which the party is entitled* and it is well-settled that, in tax refund suits, taxpayers may only recover upon the grounds presented in the claims.

that income was erroneously included in 1942 on the accrual basis. Affirmatively, the testimony of the accountant (R. 213-245) was an attempt to prove that the Delta War Venture reported the Delta contract income, in 1942, on the completed contract basis, and that this was an error resulting from his mistaken belief that the contract was completed in 1942, when it was not in fact completed until 1943. There is nothing to indicate any attempt to prove the Delta War Venture was on the accrual basis.[11] Similarly, taxpayers' position in their brief before the District Court (pp. 10-11) was that "The plaintiffs simply wish to have their 1943 income taxes computed on the basis that the income from the Delta Contract was earned in 1943, rather than in 1942" and (p. 28) "The plaintiffs, in their claims for refund, in the Complaint on file in this proceeding, and at the trial of this case, have taken the position that the completed contract method is the appropriate way to proceed. * * * It is the plaintiff's position that the law requires that the income for 1942 and 1943 be computed on a completed contract basis, and that is the only option which is open to correct the errors made."

Thus, the taxpayers' claim for refund, amended tax returns, complaint, evidence and District Court brief were based on the ground that *all* of the contract receipts had been erroneously reported as income in

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[11]As already fully discussed, the record does not present the material facts essential to a proper computation of income upon the accrual basis. (See footnotes 6 and 7, *supra.*)

1942 as a result of a mistaken application of the completed contract method, which taxpayers asserted had been elected and employed. They may not in this case seek any adjustment or correction of their accrual computation, which method they in fact utilized. If this forecloses consideration of this alternative claim, it is only because taxpayers failed to fulfill the conditions precedent to obtaining a determination on the merits. *Blum Folding Paper Box Co. v. Commissioner,* 4 T. C. 795, 801.

It might even be noted that, since the correction of the original accrual computation was not in issue, the District Court's opinion and conclusions with respect to this point are merely dictum and, in fact, the issue is raised for the first time on this appeal. Taxpayers cannot fairly urge as ground for reversal a theory which they did not present while the case was before the trial court. *Dally v. Commissioner, supra.*[12]

[12]A remand, as suggested by taxpayers (Br. 37-38), would serve no purpose in this case. The claims for refund could not be amended, inasmuch as the statute of limitations has run. Sec. 322(b), Internal Revenue Code of 1939 (26 U.S.C. 1952 ed., Sec. 322); *United States v. Garbutt Oil Co.,* 302 U.S. 528. Furthermore, there was no waiver of any defect in the claim; the claim, together with the amended returns, was specific enough and the Commissioner was entitled to take it at face value. The Commissioner was, and is, without power to consider any new grounds after the expiration of the period for filing claims. *United States v. Garbutt, supra; Cherokee Textile Mills v. Commissioner,* 5 T. C. 175, 178.

CONCLUSION.

The decision of the District Court is correct and should be affirmed.

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(Appendix Follows.)

Appendix.

Appendix

Internal Revenue Code of 1939:

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *

(26 U.S.C. 1952 ed., Sec. 41.)

SEC. 42 [as amended by Sec. 114 of the Revenue Act of 1941, c. 412, 55 Stat. 687]. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

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(26 U.S.C. 1952 ed., Sec. 42.)

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *

* * * *

(26 U.S.C. 1952 ed., Sec. 43.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.41-1. *Computation of Net Income.*—Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditure which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income,

it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See sections 29.42-1 to 29.42-3, inclusive.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

* * * *

Sec. 29.41-2. *Bases of Computation and Changes in Accounting Methods.*—Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 48 for definitions of "paid or accrued" and "paid or incurred." All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. But see sections 42 and 43. See also section 48. For instance, in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method. A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction. (See sections 29.42-2 and 29.42-3.) On the other hand, appreciation in value of property is not

even an accural of income to a taxpayer prior to the realization of such appreciation through sale or conversion of the property. (But see section 29.22(c)-5.)

The true income, computed under the Internal Revenue Code and, if the taxpayer keeps books of account, in accordance with the method of accounting regularly employed in keeping such books (provided the method so used is properly applicable in determining the net income of the taxpayer for purposes of taxation), shall in all cases be entered in the return. If for any reason the basis of reporting income subject to tax is changed, the taxpayer shall attach to his return a separate statement setting forth for the taxable year and for the preceding year the classes of items differently treated under the two systems, specifying in particular all amounts duplicated or entirely omitted as the result of such change.

A taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. For the purposes of this section, a change in the method of accounting employed in keeping books means any change in the accounting treatment of items of income or deductions, such as a change from cash receipts and disbursements method to the accrual method, or vice versa; a change involving the basis of valuation employed in the computation of inventories (see sections 29.22(c)-1 to 29.22(c)-8, inclusive); a change from the cash or accrual method to the long-term contract method, or vice versa; a change in the long-term con-

tract method from the percentage of completion basis to the completed contract basis, or vice versa (see section 29.42-4); or a change involving the adoption of, or a change in the use of, any other specialized basis of computing net income such as the crop basis (see sections 29.22(a)-7 and 29.23(a)-11). Application for permission to change the method of accounting employed and the basis upon which the return is made shall be filed within 90 days after the beginning of the taxable year to be covered by the return. The application shall be accompanied by a statement specifying the classes of items differently treated under the two methods and specifying all amounts which would be duplicated or entirely omitted as a result of the proposed change. Permission to change the method of accounting will not be granted unless the taxpayer and the Commissioner agree to the terms and conditions under which the change will be effected. See section 22(d) and regulations thereunder with respect to changing to optional method of inventorying goods.

* * * *

Sec. 29.42-4. *Long-Term Contracts.*—Income from long-term contracts is taxable for the period in which the income is determined, such determination depending upon the nature and terms of the particular contract. As used in this section the term "long-term contracts" mean building, installation, or construction contracts covering a period in excess of one year from the date of execution of the contract to the date on which the contract is finally completed and accepted. Persons whose income is derived in whole or in part

from such contracts may, as to such income, prepare their returns upon either of the following bases:

(a) Gross income derived from such contracts may be reported upon the basis of percentage of completion. In such case there should accompany the return certificates of architects or engineers showing the percentage of completion during the taxable year of the entire work to be performed under the contract. There should be deducted from such gross income all expenditures made during the taxable year on account of the contract, account being taken of the material and supplies on hand at the beginning and end of the taxable period for use in connection with the work under the contract but not yet so applied.

(b) Gross income may be reported for the taxable year in which the contract is finally completed and accepted if the taxpayer elects as a consistent practice so to treat such income, provided such method clearly reflects the net income. If this method is adopted there should be deducted from gross income all expenditures during the life of the contract which are properly allocated thereto, taking into consideration any material and supplies charged to the work under the contract but remaining on hand at the time of completion.

A taxpayer may change his method of accounting to accord with paragraph (a) or (b) of this section only after permission is secured from the Commissioner as provided in section 29.41-2.

Sec. 29.43-1. *"Paid or Incurred" and "Paid or Accrued."*—

(a) The terms "paid or incurred" and "paid or accrued" will be constructed according to the method of accounting upon the basis of which the net income is computed by the taxpayer. (See section 48(c).) The deductions and credits provided for in chapter 1 (other than the dividends paid credit provided in section 27) must be taken for the taxable year in which "paid or accrued" or "paid or incurred," unless in order clearly to reflect the income such deductions or credits should be taken as of a different period. If a taxpayer desires to claim a deduction or a credit as of a period other than the period in which it was "paid or accrued" or "paid and incurred," he shall attach to his return a statement setting forth his request for consideration of the case by the Commissioner together with a complete statement of the facts upon which he relies. However, in his income tax return he shall take the deduction or credit only for the taxable period in which it was actually "paid or incurred," or "paid or accrued", as the case may be. Upon the audit of the return, the Commissioner will decide whether the case is within the exception provided by the Internal Revenue Code, and the taxpayer will be advised as to the period for which the deduction or credit is properly allowable.

* * * *

I.T. 3459, 1941-1 Cum. Bull. 236:

Advice is requested by the M Company relative to the proper method of reporting income from a certain type of Government contract for the purpose of Federal income taxation.

The taxpayer keeps its accounts and files its returns on the accrual basis and regularly reports its income from long-term contracts for the taxable year in which each such contract is completed. It believes, however, that the completed contract basis will not be satisfactory under the terms of the particular Government contract here under consideration.

The contract in question specifies an amount of estimated aggregate cost upon the basis of which a specified fixed fee for its profit is to be paid to the M Company, the contractor. It provides for semimonthly payments (or more frequently, if justified) as earned to cover costs of construction incurred by the contractor, plus an amount computed on such costs on account of the fixed fee. The payments on account of the fixed fee are to be continued until the total amount paid equals a designated figure. The remainder of the fixed fee, less a designated reserve, is to be paid upon preliminary acceptance of the article constructed, and such reserve is to be paid upon final acceptance. An increase of the fixed fee is provided for in event that the Government increases the cost, and a bonus is provided for accelerated delivery and for saving in cost, the sum of all bonuses not to exceed a designated amount. As payments of cost and fixed fee are made by the Government, all parts constructed and materials on account of which such payments have been made immediately become the sole property of the United States, but this provision is not construed as relieving the contractor from the responsibility for the care and protection of materials and work upon which

payments have been made or as a waiver of the right of the Government to require fulfillment of all the terms of the contract. The actual cost of correcting all defects and deficiencies for which the contractor is held responsible is to be deducted from the payment in final settlement.

Upon consideration of the terms of the contract in question, the Bureau is of the opinion that the income from the contract accrues in the taxable years in which the income is earned and the right of the taxpayer to payment therefor is fixed. Therefore, it is held, in order clearly to reflect the net income, that the gross income from the contract and from other contracts of this type, including the so-called reimbursements of cost, should be reported by the taxpayer (reporting on the accrual basis) in the returns for the taxable years in which the income accrues, and there should be allowed as deductions therefrom the costs or expenses which are properly allowable as deductions under the applicable income or excess profits tax law and which are related to such gross income. (See sections 41 and 43 of the Internal Revenue Code and sections 19.41-1 and 19.43-1 of Regulations 103.) In regard to the maintenance and the preservation of adequate accounting records, see sections 41 and 54 of the Internal Revenue Code and sections 19.41-3 and 19.54-1 of Regulations 103.

This ruling is without effect upon the taxpayer's present method of reporting the income from long term contracts which may be reported on the completed contract basis.

32 Code of Federal Regulations (1944 Supp.):

CHAPTER XIV—WAR CONTRACTS PRICE ADJUSTMENT BOARD

1603.302 *Differing accounting methods.* Should there be employed a method of computing profit in a renegotiation for any fiscal year which is different from that employed in renegotiation for the fiscal year immediately preceding, the Department conducting the renegotiation must make adequate provision in the agreement or otherwise so that renegotiable business will not escape renegotiation because of the change. The interest of the Government in connection with the year which is the subject of renegotiation and for future years must also be protected and generally no item of cost which has been allowed in a previous renegotiation should be allowed in any subsequent renegotiation. These principles apply to renegotiation conducted with respect to a fiscal year, to a period other than a fiscal year or on a contract-by-contract basis. Under ordinary circumstances a contractor will be renegotiated on the same basis as that used for the determination of his income for Federal income tax purposes and, where a contractor requests and is allowed to renegotiate on some other basis, he will be required to agree that future renegotiations will be conducted on the same basis unless the War Contracts Board approves a variation of this proceeding by reason of unusual circumstances in a particular case.